

**An Evaluation of the Impact of Raising the
Threshold Requirements for Making
Estimated Tax Payments**

September 1999

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DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 20, 1999

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in black ink that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – An Evaluation of the Impact of
Raising the Threshold Requirements for Making Estimated Tax
Payments

This report presents the results of our evaluation of the impact of raising the threshold requirements for making estimated (ES) tax payments. We performed this evaluation at the request of the Assistant Commissioner (Forms and Submission Processing) to support the management decision-making process for determining whether the threshold level for making ES tax payments should be further increased to reduce taxpayer burden and lower Internal Revenue Service (IRS) processing costs.

In summary, we found that raising the ES tax payment threshold level would reduce burden on a significant number of taxpayers and lower the IRS' operating costs. Most of the taxpayers who would be affected by moderate increases to the threshold level are in the "age 65 or over" group. However, raising the threshold level could have a detrimental impact on taxpayer compliance by removing the legal requirements and discipline for making quarterly payments. Raising the threshold level would also delay the collection of taxes and result in additional borrowing costs that significantly exceed the processing cost savings that could be realized.

We made no specific recommendation as to whether the ES tax payment threshold should be increased. We believe that the IRS needs to carefully weigh the intangible value of taxpayer burden reduction against the additional costs and potential risks to taxpayer compliance before any proposed legislation to raise the threshold level is forwarded to the Congress. One method which the IRS could use to evaluate the

inherent compliance risks associated with any further increases to the ES tax payment threshold level would be to determine the impact that the last increase from \$500 to \$1,000, legislatively mandated by the Taxpayer Relief Act of 1997, had on taxpayer behavior during Tax Year 1998. This information would be available at the conclusion of the 1999 filing season.

The Chief Operations Officer expressed his appreciation for the analysis we provided and stated that the information in this report will be considered in any future policy decisions regarding ES tax payments. The response has been incorporated into the report. In addition, the complete text of the response is presented as an appendix to the report.

Copies of this report are also being sent to the IRS managers who are affected by the report. Please contact me at (202) 622-6510 if you have any questions, or your staff may call Walter Arrison, Associate Inspector General for Audit (Wage & Investment Income Programs), at (770) 455-2475.

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An Evaluation of the Impact of Raising the Threshold Requirements for Making Estimated Tax Payments

Executive Summary

We conducted this review at the request of the Assistant Commissioner (Forms and Submission Processing) to assist Internal Revenue Service (IRS) management in determining whether the threshold requirements for individual taxpayers to make estimated (ES) tax payments should be further increased to reduce taxpayer burden and lower the IRS' processing costs. Our review showed that raising the threshold level would reduce burden for a significant number of taxpayers and lower costs. However, raising the threshold level would also delay the collection of taxes and result in significant additional government borrowing costs. In addition, removing the legal requirement and discipline for making quarterly payments could have a detrimental impact on taxpayer compliance.

In 1943, the Congress established statutory requirements for withholding on salaries and wages and for making ES tax payments on certain other sources of income, such as self-employment, interest, dividends, and rent. The ES tax system "levels the playing field" between wage earners and other taxpayers and supports the "pay as you go" concept by requiring quarterly deposits.

For Tax Years (TY) 1985 through 1997, individual taxpayers were required to make ES tax payments if they expected to owe at least \$500 in tax after subtracting their withholding and other credits. This threshold level was increased to \$1,000 for TY 1998.

Results

Raising the ES tax payment threshold level would reduce burden on a significant number of taxpayers. At every \$500 increment up to \$3,500, most of the taxpayers, who would no longer be required to make ES tax payments if the threshold was increased, are in the "age 65 or over" group.

For example, we estimate that raising the ES tax payment threshold from \$1,000 to \$2,000 would:

- Require 1.6 million fewer taxpayers to make ES tax payments. These would include approximately 942,000 taxpayers (58 percent) who are age 65 or older.
- Save taxpayers from 4.5 to 5.1 million hours that are spent in preparing and submitting the necessary forms to comply with the law.
- Save taxpayers \$2.1 million in postage costs.
- Avoid the assessment of ES tax penalties against 194,000 taxpayers.

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Raising the ES tax payment threshold requirements would also reduce IRS operating costs. For example, we estimate that raising the threshold from \$1,000 to \$2,000 would result in more than \$5.9 million in printing, mailing, and processing cost savings for the IRS.

However, one potential issue with raising the ES tax payment threshold level is that currently compliant taxpayers may become accounts receivable problems for the IRS once the legal requirements and the discipline for making quarterly ES tax payments are removed. For TY 1996, we estimate that approximately \$2.6 billion was received through ES tax payments made by taxpayers with ES tax liabilities ranging from \$1,000 to \$1,999. Although our analysis indicates that these taxpayers were generally compliant (i.e., approximately 94 percent were fully paid by the regular return due date), we cannot conclusively predict their future behavior under a different set of circumstances.

A second issue with raising the ES tax payment threshold is the additional government borrowing costs that would be incurred as a result of the delayed cash flow into the Treasury. For example, we estimate that raising the threshold from \$1,000 to \$2,000 would delay the IRS' receipt of approximately \$2.6 billion in taxes and cause the government to incur more than \$66 million in additional annual borrowing costs.

Summary of Recommendations

Raising the current ES tax payment threshold level would result in a cost to the government that would exceed the process cost savings that could be realized. Therefore, any decision by the Assistant Commissioner (Forms and Submission Processing) to recommend changes to the payment requirements must be made on a basis that weighs other factors more heavily than a cost/benefit analysis.

As a result, we make no specific recommendation as to whether the ES tax payment threshold level should be further increased. We believe that the Assistant Commissioner (Forms and Submission Processing) needs to carefully balance the benefits (e.g., taxpayer burden reduction and processing cost savings) that could be realized with a higher threshold against the downsides (e.g., a potentially undesirable impact on taxpayer compliance and additional government borrowing costs) before recommending to the Congress that the Internal Revenue Code be amended to raise the threshold.

One method which the Assistant Commissioner (Forms and Submission Processing) could effectively use to evaluate the inherent compliance risk associated with any future increases to the ES tax payment threshold level would be to study the impact that the increase from \$500 to \$1,000 had on taxpayer behavior in TY 1998. This information would be available at the conclusion of the 1999 filing season.

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Management's Response: The Chief Operations Officer expressed his appreciation for the analysis that we provided at the request of the Assistant Commissioner (Forms and Submission Processing). He stated that the report contains valuable information that will be taken into consideration when making any future policy decisions regarding ES tax payments.

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Objective and Scope

We conducted this review to assist the IRS in determining whether the ES payment tax threshold should be further increased.

Our objective was to assist Internal Revenue Service (IRS) management in determining whether the threshold requirements for individual taxpayers to make estimated (ES) tax payments should be further increased to reduce taxpayer burden and lower the IRS' processing costs. To achieve this objective, we analyzed tax account information for almost 1.1 million taxpayers who filed quarterly ES payments for Tax Year (TY) 1996. We evaluated the potential impact that various higher threshold levels would have on taxpayer burden, operating costs, taxpayer compliance, and government borrowing costs.

We conducted the review from April through September 1998 using *Government Auditing Standards*. Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

The Current Tax Payment Act of 1943 established statutory requirements for withholding on salaries and wages and making ES tax payments on certain other sources of income.

Taxpayers who are wage earners have income taxes and Social Security taxes withheld from their paychecks on a regular basis. The ES tax system supports the "pay as you go" concept by requiring quarterly deposits from taxpayers who are self-employed and/or have earnings from such sources as interest, dividends, rent, alimony, and unemployment compensation.

Approximately 11 million individual taxpayers make ES tax payments each year. During Fiscal Year (FY) 1997, the IRS collected nearly \$140 billion from the 39.1 million ES tax payments that were received.

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The Taxpayer Relief Act of 1997 increased the threshold for requiring ES tax payments from \$500 to \$1,000 for taxable years beginning in 1998.

Beginning in TY 1998, individual taxpayers will generally be required to make ES tax payments if they expect to owe at least \$1,000 in taxes after subtracting their withholding and other credits. This is the first change to the ES tax payment threshold level since 1985. Previously, the threshold had been set at \$100 beginning in TY 1981, \$200 in TY 1982, \$300 in TY 1983, \$400 in TY 1984, and \$500 in TY 1985.

Results

Any changes to the ES tax payment requirements for individual taxpayers involve a consideration of both tangible and intangible factors. The Assistant Commissioner (Forms and Submission Processing) needs to carefully weigh the intangible value of taxpayer burden reduction against the potential risks and cost factors before proposing any changes to the current tax law.

If the threshold level was increased, our analyses showed that:

- Taxpayer burden would be reduced.
- IRS operating costs would be reduced.
- Accounts receivable could be increased.
- Additional government borrowing costs would be incurred.

We make no specific recommendation as to whether the ES tax payment threshold level should be further increased. Instead, the balance of this report presents the results of our analysis of the factors that the Assistant Commissioner (Forms and Submission Processing) needs to consider before proposing any changes to the current payment requirements.

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Raising the Estimated Tax Payment Threshold Level Would Reduce Taxpayer Burden

We estimate that the recent tax law change which increased the threshold from \$500 to \$1,000 removed the requirement for making ES tax payments from 1,002,000 taxpayers who had made one or more quarterly payments in TY 1996. Of these, we estimate that 605,000 (60 percent) were age 65 or over.

Taxpayer burden would be reduced for a significant number of taxpayers if the threshold requirement for making ES tax payments was further increased. Most of the taxpayers who would benefit from moderate increases to the threshold level are those in the “age 65 or over” group.

Over half of the taxpayers who would be impacted by raising the ES tax payment threshold to \$2,000 are age 65 or over.

For example, we estimate that doubling the threshold from \$1,000 to \$2,000 would:

- Cause 1.6 million taxpayers who made ES tax payments in TY 1996 to no longer be required to make them. These would include nearly 942,000 taxpayers (58 percent) who are age 65 or older.
- Save taxpayers from 4.5 to 5.1 million hours that are spent in preparing and submitting the necessary IRS forms.
- Save taxpayers \$2.1 million in postage costs.
- Avoid the assessment of ES tax penalties against 194,000 taxpayers.

Fewer Taxpayers Would Be Subject to ES Tax Payment Requirements

For TY 1996, over 11 million individual taxpayers made one or more ES tax payments. The following table, which is arranged according to estimated tax liability, is presented to show our estimate of the number of taxpayers who made ES tax payments within each \$500 increment:

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Estimated Number of Taxpayers Making ES Tax Payments TY 1996

More than 1 million taxpayers were affected by the recent increase in the threshold from \$500 to \$1,000.

The number of applicable taxpayers declines with each \$500 incremental increase in ES tax liability.

<u>ES Tax Liability</u>	<u>Estimated Number of Taxpayers Who Made ES Tax Payments</u>	<u>Estimated Number of Age 65 or Over Taxpayers Who Made ES Tax Payments</u>
\$ 500 - \$ 999	1,002,000	604,980 (60.4%)
\$1,000 - \$1,499	900,550	533,240 (59.2%)
\$1,500 - \$1,999	726,710	408,690 (56.2%)
\$2,000 - \$2,499	593,060	313,900 (52.9%)
\$2,500 - \$2,999	517,730	268,330 (51.8%)
\$3,000 - \$3,499	450,750	229,660 (51.0%)
\$3,500 - \$3,999	372,430	178,350 (47.9%)
\$4,000 - \$4,499	326,380	151,090 (46.3%)

At each increment up to \$3,500, taxpayers who were age 65 or over comprised more than 50 percent of the population who made ES tax payments. The following table shows our estimate of the cumulative number of taxpayers, including those age 65 or older, who would no longer be required to make ES tax payments at various higher ES tax payment threshold levels:

Estimated Number of Taxpayers No Longer Required to Make ES Tax Payments at Various Higher Threshold Levels TY 1996

Most of the taxpayers who would benefit from any further increases to the ES tax payment threshold are in the age 65 or over group.

<u>New Threshold</u>	<u>Estimated Number of Taxpayers No Longer Required to Make ES Tax Payments</u>	<u>Estimated Number of Taxpayers Age 65 or Over No Longer Required to Make ES Tax Payments</u>
\$1,500	900,550	533,240 (59%)
\$2,000	1,627,260	941,930 (58%)
\$2,500	2,220,320	1,255,830 (57%)
\$3,000	2,738,050	1,524,160 (56%)
\$3,500	3,188,800	1,753,820 (55%)

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Fewer Hours Would Be Spent by Taxpayers in Preparing and Submitting the Necessary Forms

We estimate that the 11 million individual taxpayers who currently make ES tax payments spend approximately 29.3 million hours in complying with the basic paperwork requirements of the existing ES tax payment laws. We estimate that about 1.6 million of these taxpayers spend an additional 1.6 million hours (short method) to 6 million hours (long method) in completing the form used to compute ES tax penalties.

ES Tax for Individuals (Form 1040-ES/V)

The IRS provides a Form 1040-ES/V package to those taxpayers who make ES tax payments. The package includes a worksheet for determining how much ES tax to pay and four payment vouchers (Forms 1040-V) which are preprinted with the taxpayer's name, address, and social security number.

For TY 1998, the IRS' estimate of the average amount of time that taxpayers would need to spend on completing the worksheets and preparing and filing the payment vouchers was 2 hours and 40 minutes.

IRS Estimate of Taxpayer Burden Associated with Forms 1040-ES/V – TY 1998

In TY 1997, taxpayers spent an estimated 29.3 million hours on Forms 1040-ES/V.

Task	<u>Estimated Time</u>
Recordkeeping	79 minutes
Learning about the law	22 minutes
Preparing the worksheets and payment vouchers	49 minutes
Copying, assembling, and sending the payment voucher to the IRS	<u>10 minutes</u>
Total	160 minutes

The table on the following page shows our estimate of how taxpayer burden associated with Forms 1040-ES/V

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would be affected at various higher ES tax payment threshold levels:

Estimated Taxpayer Hours Saved at Higher Threshold Levels in Preparing/Filing Forms 1040-ES/V – TY 1996

Raising the threshold to \$2,000 would save taxpayers more than 4.3 million hours in completing Forms 1040ES/V.

<u>New Threshold</u>	<u>Number of Taxpayers No Longer Required to Make ES Tax Payments</u>	<u>Hours Saved in Preparing/Filing Form 1040-ES/V</u>
\$1,500	900,550	2,401,467
\$2,000	1,627,260	4,339,360
\$2,500	2,220,320	5,920,853

Underpayment of ES Tax by Individuals, Estates, and Trusts (Form 2210)

Taxpayers are instructed to use Form 2210 to determine if they are liable for an ES tax penalty and, if so, to calculate the penalty. Because the Form 2210 is complicated, the IRS encourages taxpayers to let the IRS compute the penalty and bill them for the amount due.

Of the approximately 11 million taxpayers who made ES tax payments for TY 1996, 1,923,000 taxpayers incurred ES tax penalties. Of these taxpayers, 1,605,000 (83 percent) self-assessed the penalties using Forms 2210.

As shown in the following table, for TY 1997, the IRS estimate of the average amount of time that taxpayers would need to spend completing and filing Form 2210 ranged from 61 minutes, if taxpayers used the "short method",¹ to 3 hours and 44 minutes, if taxpayers used the "long method."²

¹ The "short method" requires taxpayers to only complete a small section of the Form 2210 and to make limited calculations in computing the ES tax penalty. Taxpayers may use the "short method" only if they made no ES tax payments, or they paid ES tax in four equal amounts on the due dates.

² The "long method" requires taxpayers to use a larger section of the Form 2210 and to make more involved calculations of their underpayment amount. The "long method" must be used by taxpayers who are not eligible to use the "short method."

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IRS Estimate of the Taxpayer Burden Associated with Form 2210 – TY 1997

The time required to complete and file Form 2210 ranges from 61 minutes to 3 hours and 44 minutes.

<u>Task</u>	<u>Short Method</u>	<u>Long Method</u>
Recordkeeping	7 minutes	13 minutes
Learning about the law or the form	5 minutes	38 minutes
Preparing the form	29 minutes	127 minutes
Copying, assembling, and sending the form to IRS	<u>20 minutes</u>	<u>46 minutes</u>
Total	<i>61 minutes</i>	<i>224 minutes</i>

The following table shows our estimate of the cumulative number of taxpayer hours associated with Forms 2210 that would be avoided at various higher ES tax payment threshold levels:

Estimated Taxpayer Hours Saved at Higher Threshold Levels in Preparing Forms 2210 – TY 1996

<u>New Threshold</u>	<u>Estimated Number of Taxpayers Who Would No Longer File Form 2210</u>	<u>Hours Saved in Preparing Form 2210-Short Method</u>	<u>Hours Saved in Preparing Form 2210-Long Method</u>
\$1,500	100,460	102,134	375,051
\$2,000	193,860	197,091	723,744
\$2,500	277,070	281,688	1,034,395

Raising the threshold to \$2,000 would save more than 193,000 taxpayers from spending from 197,000 to 724,000 hours in completing Forms 1040ES/V.

Postage Costs Would Be Reduced

The following table shows our estimate of the cumulative amount of postage costs that taxpayers would avoid at various higher ES tax payment threshold levels:

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Estimated Postage Costs Avoided at Higher Threshold Levels - TY 1996

Raising the threshold to \$2,000 would save taxpayers nearly \$2.1 million in postage costs.

<u>New Threshold</u>	<u>Number of Taxpayers No Longer Required to Make ES Tax Payments</u>	<u>Postage Costs Avoided</u>
\$1,500	900,550	\$1,152,704
\$2,000	1,627,260	\$2,082,893
\$2,500	2,220,320	\$2,842,010

The above estimate is based on the assumption that each of the affected taxpayers would have mailed four ES tax payment vouchers to the IRS at a postage cost of \$.32 each.

Fewer ES Tax Penalties Would Be Assessed

An ES tax penalty is imposed on those taxpayers who were required to make payments but did not pay enough estimated taxes throughout the year or did not make the payments on time. Taxpayers are exempted from ES tax penalties if their withholding and ES tax payments were at least 90 percent of their current year tax liability or at least 100 percent of their prior year tax liability.

Of the approximately 11 million taxpayers who made one or more ES tax payments for TY 1996, 1,923,000 (17.5 percent) incurred ES tax penalties.

The following table shows our estimate of the cumulative number of these taxpayers who would have avoided ES tax penalties at various higher ES tax payment threshold levels:

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Estimated Number of ES Tax Penalties Avoided at Higher Threshold Levels – TY 1996

Raising the threshold to \$2,000 would prevent the assessment of nearly 194,000 ES tax penalties.

<u>New Threshold</u>	<u>Number of Taxpayers No Longer Required to Make ES Tax Payments</u>	<u>Number of ES Tax Penalties Avoided</u>
\$1,500	900,550	100,490
\$2,000	1,627,260	193,990
\$2,500	2,220,320	278,100

The estimated number of ES tax penalties that would be avoided at higher threshold levels includes penalties self-assessed by taxpayers on Forms 2210 and penalties assessed by the IRS.

Raising the Estimated Tax Payment Threshold Level Would Reduce Internal Revenue Service Operating Costs

Raising the ES tax payment threshold to \$2,000 would save the IRS more than \$5.9 million in annual operating costs. These savings would include:

- An estimated \$472,000 in printing and mailing costs for the Form 1040-ES/V packages.
- An estimated \$5,468,000 in remittance processing costs.

In addition, there would be additional undetermined cost savings to the Department of the Treasury's Financial Management Service (FMS).

Printing and Mailing Costs Would be Reduced

We were advised that it costs the IRS \$.29 to print and mail each Form 1040-ES/V package. The following table shows the printing and mailing cost savings that could be realized incrementally at various higher ES tax payment threshold levels:

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Estimated Printing/Mailing Cost Savings at Higher Threshold Levels – TY 1996

Raising the threshold to \$2,000 would save the IRS an estimated \$472,000 in printing and mailing costs.

<u>New Threshold</u>	<u>Number of Taxpayers No Longer Required to Make ES Tax Payments</u>	<u>IRS Printing & Mailing Costs: Form 1040-ES/V Packages</u>
\$1,500	900,550	\$261,160
\$2,000	1,627,260	\$471,905
\$2,500	2,220,320	\$643,893

IRS Remittance Processing Costs Would be Reduced

Taxpayers are required to send their quarterly ES tax payments to certain commercial Lockbox Banks, which process the payments and credit the amounts to the Treasury's deposit account for a per-item fee. The per-item fee, which varies from bank to bank depending upon the contract terms negotiated with the bank, is paid by the FMS.

The Lockbox Banks record the payment and payer information on computer tapes that are shipped to the IRS service centers for updating the taxpayer accounts. On a daily basis, the Lockbox Banks forward processed ES tax vouchers and unprocessable work from the previous day to the IRS service centers.

The IRS' cost to process each ES tax payment is 84 cents.

A total of 39.1 million ES tax payments were received during FY 1997. The most current information available shows that it costs the IRS \$838.75 to process 1,000 ES tax payments, or an average of \$.84 per payment. The following table shows the remittance processing cost savings that could be realized incrementally at various higher ES tax payment threshold levels, assuming that each taxpayer made four quarterly payments:

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Estimated Processing Cost Savings at Higher Threshold Levels – TY 1996

Raising the threshold to \$2,000 could save the IRS an estimated \$5.5 million in remittance processing costs.

<u>New Threshold</u>	<u>Number of Taxpayers No Longer Required to Make ES Tax Payments</u>	<u>IRS Remittance Processing Cost Savings</u>
\$1,500	900,550	\$3,025,848
\$2,000	1,627,260	\$5,467,594
\$2,500	2,220,320	\$7,460,275

Raising the Estimated Tax Payment Threshold Level Could Have an Undesirable Impact on Accounts Receivable

One potential issue with raising the ES tax payment threshold level is that currently compliant taxpayers may become accounts receivable problems for the IRS once the legal requirements and the discipline for making quarterly ES tax payments are removed. While we cannot conclusively predict taxpayer behavior under a different set of requirements, the approximately \$2.6 billion that was collected for TY 1996 through ES tax payments from taxpayers with ES tax liabilities ranging from \$1,000 to \$1,999 could be put at some risk if the threshold level was raised to \$2,000.

Our analysis of TY 1996 accounts showed that those taxpayers who made ES tax payments and had ES tax liabilities (i.e., income tax minus withholding) ranging from \$1,000 to \$1,999 generally were compliant. In the aggregate, the total ES tax payments made by these taxpayers exceeded their total ES tax liabilities by approximately \$189.5 million. Individually, about six percent of these taxpayers were underpaid by the tax return due date.

Payment levels generally decreased as taxpayer liabilities increased.

However, the ratio of total ES tax payments made to total ES tax liability declined as the ES tax liability increased. For example, the following table shows that the ratio of total ES tax payments made to total ES tax

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liability declined from 113 percent to 104 percent to 97 percent as the ES tax liability increases from the \$1,000-\$1,499 strata to the \$1,500-\$1,999 strata and \$2,000-\$2,499 strata, respectively.

Comparison of Total ES Tax Liability with Total ES Tax Payments at Various Potential Threshold Levels TY 1996

	<u>ES Tax Liability:</u> <u>\$1,000-\$1,499</u>	<u>ES Tax Liability:</u> <u>\$1,500-\$1,999</u>	<u>ES Tax Liability:</u> <u>\$2,000-\$2,499</u>
Number of Taxpayers	900,550	726,710	593,060
Total ES Tax Liability	\$1,117,725,374	\$1,264,871,043	\$1,330,417,664
Total ES Tax Payments	\$1,262,763,050 (113%)	\$1,309,283,547 (104%)	\$1,288,146,157 (97%)
(Over)/Under Payment	(\$145,037,676)	(\$44,412,504)	\$42,271,507

By our estimate, 1,002,000 taxpayers with ES tax liabilities ranging from \$500 to \$999 (i.e., the strata affected by the 1998 tax law change which increased the threshold to \$1,000) and making ES tax payments for TY 1996 were overpaid by an aggregate of more than \$290 million. The total ES tax payments made by these taxpayers represented 139 percent of their total ES tax liabilities.

Similarly, the following table shows that the rate of underpayment³ on April 15, 1997 -- the due date of the 1996 tax return -- also increased as the ES tax liability increased. For example, taxpayers with ES tax liabilities ranging from \$1,000 to \$2,999 were about three times more likely to be underpaid than those taxpayers with ES tax liabilities below \$1,000.

³ Total tax liability less total credits posted to account on or before April 15, 1997.

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Rate of Underpayment by Return Due Date at Various ES Tax Liability Levels – TY 1996

Each increase to the ES tax payment threshold level would remove the legal requirement and discipline for making quarterly payments from taxpayers who progressively present more of an accounts receivable risk to the IRS.

<u>ES Tax Liability</u>	<u>Total Taxpayers</u>	<u>% Underpaid on 4/15/97</u>	<u># Underpaid on 4/15/97</u>
< \$1,000	2,402,730	2.0%	48,055
\$1,000 - \$1,499	900,550	5.9%	53,132
\$1,500 - \$1,999	726,710	5.9%	42,876
\$2,000 - \$2,999	1,110,790	5.9%	65,537
\$3,000 - \$3,999	823,180	10.5%	86,434
\$4,000 - \$4,999	620,850	9.3%	57,739

In summary, this data indicates that raising the ES tax payment threshold level to \$2,000 or higher could expose the IRS to more risk for collection problems than is being presently incurred by increasing the threshold from \$500 to \$1,000.

Raising the Estimated Tax Payment Threshold Level Would Create Additional Government Borrowing Costs

When taxpayers make four quarterly payments, the government has the use of the money for an average of eight months. The following table shows the calculation of the average deposit period for ES tax payments made timely for TY 1996.

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Calculation of Average Deposit Period for ES Tax Payments TY 1996

When taxpayers make four quarterly ES tax payments, the government has the use of the money for an average of eight months.

<u>ES Tax Payment Number</u>	<u>Payment Due Date</u>	<u>Deposit Period</u>	<u>Length of Time Deposited</u>
# 1	4/15/96	4/15/96-4/15/97	12 months
# 2	6/15/96	6/15/96-4/15/97	10 months
# 3	9/15/96	9/15/96-4/15/97	7 months
# 4	1/15/97	1/15/97-4/15/97	<u>3 months</u>
<u>Total</u>			32 months
<u>Average</u>			8 months

The most significant drawback to raising the ES tax payment threshold is the resultant impact it would have on cash flow into the Treasury. At the \$2,000 threshold level, for example, the estimated 1,627,000 taxpayers who currently make quarterly ES tax payments would instead pay the taxes they owe when they file their return on April 15 of each calendar year.

For one tax year, we estimate that raising the threshold from \$1,000 to \$2,000 would delay the receipt of more than \$2.6 billion in taxes and would cost the government more than \$66 million in additional borrowing costs.

The following table shows the estimated additional government borrowing costs that would be incurred at various higher ES tax payment threshold levels. For the purposes of this estimate, we applied the 26-Week Treasury bill yield (3.865 percent) that was being earned on October 22, 1998, to the total ES tax payments that were received and factored in the average 8-month deposit period.

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Estimated Additional Government Borrowing Costs Incurred at Higher Threshold Levels – TY 1996

Each \$500 increase in the ES tax payment threshold results in more than \$30 million in additional government borrowing costs.

<u>New Threshold</u>	<u>Total ES Tax Payments Made by Taxpayers Who Would No Longer Be Required to Make ES Tax Payments</u>	<u>Additional Government Borrowing Costs</u>
\$1,500	\$1,262,763,050	\$ 32,553,463
\$2,000	\$2,572,046,597	\$ 66,306,204
\$2,500	\$3,860,192,754	\$ 99,514,032

Recommendation

We make no specific recommendation as to whether the ES tax payment threshold level for individual taxpayers should be further increased. The Assistant Commissioner (Forms and Submission Processing) needs to carefully balance the benefits (e.g., taxpayer burden reduction and processing cost savings) that could be realized with a higher threshold against the potential downsides (e.g., impact on taxpayer compliance and additional government borrowing costs) before recommending to the Congress that the Internal Revenue Code be amended to raise the threshold.

One method which the Assistant Commissioner (Forms and Submission Processing) could effectively use to evaluate the inherent compliance risk associated with any future increases to the ES tax payment threshold level would be to study the impact that the increase from \$500 to \$1,000 had on taxpayer behavior in TY 1998. This information would be available at the conclusion of the 1999 filing season.

Management's Response: The Chief Operations Officer expressed his appreciation for the analysis that we provided at the request of the Assistant Commissioner (Forms and Submission Processing). He stated that the

An Evaluation of the Impact of Raising the Threshold Requirements for Making Estimated Tax Payments

report contains valuable information that will be taken into consideration when making any future policy decisions regarding ES tax payments.

Conclusion

Raising the ES tax payment threshold requirements from \$1,000 to a higher level would reduce burden for a significant number of taxpayers and cut the IRS' operating costs. Most of the taxpayers who would be affected by moderate increases to the threshold level are in the "age 65 or over" group.

However, raising the threshold level could have a detrimental impact on taxpayer compliance by removing the legal requirements and discipline for making quarterly payments. Raising the threshold level would also delay the collection of taxes and result in significant additional government borrowing costs. These two issues need to be carefully considered against the intangible value of taxpayer burden reduction before any proposed legislation is forwarded to the Congress.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to assist Internal Revenue Service (IRS) management in determining whether the threshold requirements for individual taxpayers to make estimated (ES) tax payments should be further increased to reduce taxpayer burden and lower the IRS' processing costs. To accomplish our objective, we:

- I. Obtained a Masterfile extract of all individual income tax modules with ES tax payments for Tax Years (TY) 1996 and 1997 and analyzed a sample of almost 1.1 million of the TY 1996 accounts identified to develop information on the characteristics of the taxpayer population which makes ES tax payments.
- II. Stratified the accounts identified according to the amount of the taxpayer's ES tax (i.e., tax liability less withholding credits). The strata included the following: \$500-\$999; \$1,000-\$1,499; \$1,500-\$1,999; \$2,000-\$2,499; \$2,500-\$2,999; \$3,000-\$3,499; \$3,500-\$3,999; and \$4,000-\$4,499. For each of these dollar levels, we also developed sub-strata for taxpayers who are under age 65 and taxpayers who are age 65 or older.
 - A. Determined the number of taxpayers involved at each dollar level.
 - B. Calculated the total amount of ES tax payments made at each dollar level.
 - C. Calculated the total underpayment amount at each dollar level (tax liability less withholding credits less ES tax payments.)
 - D. Calculated the total amount of ES tax penalties assessed at each dollar level.
 - E. Determined the number of taxpayers assessed ES tax penalties at each dollar level.
- III. Evaluated the feasibility of allowing certain taxpayers who currently make quarterly ES tax payments to, instead, fully pay the amount owed with their return by assessing its potential impact on taxpayer burden, third party stakeholders, compliance, revenue, and processing costs.
 - A. Impact on taxpayer burden
 1. Determined the number of taxpayer accounts from each strata (i.e., \$500-\$999; \$1,000-\$1,499; \$1,500-\$1,999; \$2,000-\$2,499; \$2,500-\$2,999; \$3,000-\$3,499; and \$3,500-\$3,999). Determined the number with self-assessed and/or IRS-assessed ES tax penalties.

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2. Obtained an IRS estimate of the time those taxpayers who self-assessed ES tax penalties took to complete and file the complex Form 2210 and developed an estimate of the time those taxpayers would save if the ES tax penalty was eliminated at certain dollar levels.
 3. Developed estimates of the time spent by taxpayers in preparing and filing the ES tax payment vouchers and the mailing costs which they incurred.
 4. Developed sub-strata for taxpayers under age 65 and taxpayers age 65 or older.
- B. Effect on third party stakeholders
1. Interviewed the Assistant Commissioner (Forms and Submission Processing) to solicit his views on the potential benefits and/or barriers to changing the current ES tax deposit requirements.
 2. Contacted the Director, Office of Penalty and Administration, to determine if there were any developing plans for implementing modifications to the administration of the ES tax penalty.
- C. Effect on taxpayer compliance
1. Selected a statistically valid random sample of taxpayer accounts from each of the following estimated tax strata: under \$1,000; \$1,000-\$1,499; \$1,500-\$1,999; \$2,000-\$2,999; \$3,000-\$3,999; and \$4,000- \$4,999. The sample size in each strata was sufficient to provide a 95 percent confidence level that the results were accurate within a precision of 3 percent.
 2. Requested and analyzed Masterfile Transcripts for the sampled taxpayers in each dollar level to determine:
 - a) The number and percentage of taxpayers that timely fully paid all taxes owed on their TY 1996 Form 1040 by the April 15, 1997, return due date.
 - b) The number and percentage of taxpayers who were underpaid on the regular April 15, 1997, return due date.
 - c) The number and percentage of taxpayers who had not fully paid their tax liability 6 months after the regular return due date.
 - d) The number and percentage of taxpayers who had not fully paid their tax liability 12 months after the original due date of the return.

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D. Effect on revenue/costs

1. Performed analyses at various dollar levels to determine an optimal threshold amount:
 - a) Calculated the IRS cost savings that could be realized at higher threshold levels by printing and mailing fewer payment voucher packages and processing fewer ES tax vouchers.
 - b) Estimated the reduction in the number of penalty abatements and adjustment costs that would exist at higher threshold levels.
 - c) Developed estimates of the cash flow lags that would result from the higher threshold levels.

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Appendix II

Major Contributors to This Report

Walter Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs)

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Appendix III

Report Distribution List

Chief Operations Officer OP

Assistant Commissioner (Forms and Submission Processing) OP:FS

Assistant Commissioner (Program Evaluation and Risk Analysis) M:OP

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Appendix IV

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

CHIEF OPERATIONS OFFICER

March 23, 1999

**MEMORANDUM FOR ACTING TREASURY INSPECTOR GENERAL FOR
TAX ADMINISTRATION**

FROM:

John M. Dalrymple
Chief Operations Officer

A handwritten signature in black ink, appearing to read "John M. Dalrymple", written over the printed name.

SUBJECT:

Review of Estimated Tax Payment Requirements for
Individual Taxpayers – Requested by the Assistant
Commissioner (Forms and Submission Processing)

I would like to express my appreciation for the excellent analysis your staff has provided at the request of the Assistant Commissioner (Forms and Submission Processing). The report contains valuable information that we will certainly take into consideration when making any future policy decisions regarding estimated tax payments.

If you have any questions or wish to discuss this further, please give me a call at 622-6860 or your staff may call Brien T. Downing, Assistant Commissioner (Forms and Submission Processing), at 622-2875.